

**REPORT TO THE SECRETARY OF THE TREASURY  
FROM THE  
TREASURY BORROWING ADVISORY COMMITTEE  
OF THE  
SECURITIES INDUSTRY AND  
FINANCIAL MARKETS ASSOCIATION**

July 31, 2007

Dear Mr. Secretary:

Since the Committee's previous meeting in May, the economic expansion has expanded unevenly with growth this spring rebounding from a temporarily soft first quarter. Steady increases in profits and employment point to sustained gains in activity in coming months, while financial market conditions have continued to be generally supportive of expansion. Nonetheless, the repricing of risk in some segments of the capital markets and few signs of stabilization in the housing downturn suggest that GDP will remain on a relatively modest track ahead.

Inflation has remained on an elevated path this year largely as a result of faster price increases for food and energy. There are some signs that the slowing in economic growth has had a moderating effect on a wide array of other consumer prices, most notably autos and other large household goods. As a result, core consumer price measures have slowed from a 2½-3% range to a 2-2¼% rate. Although policymakers anticipate some slight further improvement, the persistence of tight labor markets and high and rising prices for energy and other commodities have kept alive concerns that price pressures may not be fully contained.

The protracted weakness in housing and recent setbacks in credit and equity markets have triggered a revival of expectations for Fed easing over the next year following a brief spike in yields in June. Nonetheless, the economy's uneven path combined with lingering inflation uncertainty has contributed to a modest steepening in the yield curve as market rates have edged back down. Yields in the longer end of the U.S. Treasury market are about even with May levels, while short to intermediate term yields are 10 to 25 basis points lower on balance.

The Federal Government's fiscal balance continues to improve as individual and corporate tax receipts surpass expectations. At the same time, public expenditures are rising at a slower pace than in recent years.

The Treasury opened the meeting with a presentation labeled "Presentation to the Treasury Borrowing Advisory Committee" dated July 31, 2007. The presentation highlighted the continued improvement in the fiscal position of the U.S. budget and the commensurate improvement in the projection of net marketable borrowing needs.

The Office of Management and Budget (OMB) released its mid-session review recently and revised its FY07 budget deficit forecast down from \$244 billion to \$205 billion. And further, a recent survey of Treasury Primary Dealers is projecting on average a deficit of only \$161 billion for this same period. The deficit projections have improved as individual and corporate tax receipts continue to outpace expectations while Federal outlays remain tepid and have shown the smallest rate of growth in recent years.

The improvement in the fiscal situation coupled with very strong non-marketable issuance for this same period has significantly reduced the near-term net marketable issuance needs. For example, the Treasury is now projecting net marketable borrowing needs for FY07 of approximately \$100 billion which is a sharp reduction from the needs of the last several years where the net marketable borrowing was approximately \$200 billion, \$225 billion and \$375 billion for FY06, FY05 and FY04, respectively.

Consequently, despite several steps taken by Treasury over the last eighteen months to adjust its coupon issuance calendar including, the recently announced elimination of 3-year notes, the mix of the outstanding debt has changed significantly. For example, the amount of outstanding Treasury bills has fallen below the \$900 billion level for the first time in many years, as the shortest maturities have borne the brunt of the reduced borrowing needs.

In light of the continuation of the improvement in the fiscal outlook and reduced borrowing needs, the Treasury again asked the Committee for its advice on Treasury debt issuance. The Committee discussed three primary alternatives for the Treasury to consider in alleviating the pressure on the reduction of outstanding bills and yet preserving the mandate of regular and predictable issuance and achieving the lowest effective borrowing costs for the Government. These three options included, in no particular order of preference: the elimination of 5-year TIPs issuance, a reduced issuance of 10-year Treasury notes to a quarterly cycle and the re-introduction of a buy-back program.

The primary consensus on the Committee was that the Treasury should endeavor to ensure that there is an adequate supply of newly issued benchmark securities (2, 5, 10 and 30-year) available in the marketplace to maintain orderly and liquid markets and provide the Treasury with reduced borrowing costs commensurate with the benefits such liquidity affords the marketplace.

There was a general consensus that the 5-year TIPs represent the least attractive of the TIPs maturities to the end user while at the same time, others expressed that the issuance of this security does help provide an easy to measure yield curve for TIPs and for inflation expectations in general.

There was also a consensus on the Committee that if the Treasury were to revive the buy-back program that it should focus on a broader range of maturities than had been seen in prior periods.

In the second section of the charge, the Committee was asked for its thoughts on the benefits and challenges posed by the growing number and size of Sovereign Wealth Funds initiated to complement the management of foreign exchange reserves.

A member of the Committee led a discussion on the topic with a review of foreign exchange reserve investment trends. This member pointed out that Sovereign Wealth Funds impact on markets, while not insignificant, only equals 1½-2% of global financial assets under management. Their diversification of portfolio holdings was described as an incremental and gradual process into higher yielding spread and equity products rather than into other currencies, with only a modest impact on financial asset valuations. This member concluded by acknowledging the challenges posed by growth in these vehicles to include possible increases in systemic risk and asset market volatility, lack of disclosure and accountability and increased risk of financial protectionism as a response.

Other Committee members agreed that the diversification process is a natural evolution and should not be interfered with. One member urged that with respect to transparency and disclosure issues the focus should be limited to governance, process and risk management as opposed to their specific holdings.

Members generally felt that active reserve management by these vehicles was not materially different than that performed by other investors and that primary actors in the marketplace are constantly changing. Most agreed that their size was not of consequence relative to other investor types. If there was any concern at all, it was that investment decisions could be made for political or strategic country specific reasons and that foreign direct investment constraints being discussed in certain G-7 countries could lead to inappropriate financial protectionism.

In its third charge, Treasury sought the Committee's perspective on the costs of inaction regarding entitlement reform. One member of the Committee presented an analysis of projected Treasury issuance and interest expense under what was described as three relatively "conservative" assumptions, all of which were originally developed by the Congressional Budget Office (CBO). In spite of the relatively conservative assumptions used, the results of the analysis were disturbing to all members of the Committee and highlighted quite strongly that without significant reform to entitlement programs, the strains on Treasury to finance the projected deficits over the next 40 years are dramatic and would undoubtedly result in a significant increase in "real" borrowing costs by the U.S. Government. For example, even under the most optimistic assumptions used, 2-year note issuance would be nearly \$380 billion per month by 2050. To put this in perspective, gross coupon issuance will need to be between four and fifteen times as large as today's in relation to the size of the economy.

In the final section of the charge, the Committee considered the composition of marketable financing for the July-September quarter to refund approximately \$62.6 billion of privately held notes and bonds maturing on August 15, 2007, as well as the composition of marketable financing for the remainder of the quarter, including cash

management bills, as well as the composition of marketable financing for the October-December quarter.

To refund \$62.6 billion of privately held notes and bonds maturing on August 15, 2007, the Committee recommended a \$13 billion 10-year note due August 15, 2017 and a \$9 billion 30-year bond due May 15, 2037. For the remainder of the quarter, the Committee recommended \$18 billion 2-year notes in August and September, a \$13 billion 5-year note in August and September and an \$8 billion re-opening of the 10-year note in September. The Committee also recommended a \$30 billion 17-day cash management bill issued August 31, 2007 and maturing September 17, 2007 and a \$25 billion 11-day cash management bill issued September 6, 2007 and maturing September 17, 2007, as well as a \$10 billion 4-day cash management bill issued September 13, 2007 and maturing September 17, 2007.

For the October-December quarter, the Committee recommended financing as found in the attached table. Relevant features include three 2-year note issuances monthly, three 5-year note issuances monthly, a 10-year note issuance in November with a re-opening in December, a 30-year bond re-opening in November, as well as a 10-year TIPs re-opening in October and a 5-year TIPs re-opening in October.

Respectfully submitted,

Thomas G. Maheras  
Chairman

Keith T. Anderson  
Vice Chairman

Attachments (2)

Table Q3

Table Q4